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## Supply-Side Fallacy

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# Supply-Side Fallacy. Rubbish Economics In The White House

By Sven Brendel

## *Summary*

*Since the early 1980s Supply-side economics, the idea that cutting the taxes of the rich will generate sufficient economic growth to off-set the cost of tax-cuts and increase government revenue, has been at the heart of the political right's economic agenda despite having failed in practice. The idea relies on the erroneous concept that the relationship between tax revenue, economic growth and tax rates is represented by a simple bell curve, according to which neither a tax rate of 0% nor of 100% will produce any revenue. Such is not the case, however, as a tax rate of 100% will yield revenue. The most efficient tax rate depends upon the usage of tax funds, which can increase or decrease the economy's tolerance for a given tax rate. It is vital that the American people stop supply-side economics, join America's economists, and help reduce income inequality, balance the budget and provide the government with needed funds for investment in social services and infrastructure.*

Imagine a theory that defies common sense and is decried by experts in the field as laughable. Imagine this theory becoming policy and failing miserably, producing none of its promised outcomes. After being put aside as a failed experiment for eight years, imagine this theory being reinstated as policy, producing nothing but the negative side effects it produced a decade earlier. Voila: Supply-side economics and the political right. Supply-side economics, once more popularly known as Reaganomics, rests on the assumption that lowering the tax rates of the rich will spur economic growth and, therefore, increase government revenue. Since the early 1980s, supply-side economics has become part of the GOP dogma. Support for a Republican president has come to coincide with support of Reaganomics, giving seemingly

endless tax cuts to the rich, who are already pulling far ahead of everyone else.

Most economists, however, continue to regard cutting the taxes of the rich in order to increase revenue as a rubbish theory. Even George Bush Sr. had the good sense to greet Reagan's supply-side theory as "voodoo economics" when first confronted with it (though he miraculously changed his mind after being offered the vice presidency). According to the late Nobel price laureate and Harvard economics professor James Tobin, "... [The] idea that tax cuts would actually increase revenues turned out to deserve the ridicule with which sober economists had greeted it in 1981." Supply-side economics has failed to create the tremendous economic growth it promised. Instead, it has increased income inequality and lead to the

creation of the most massive budget deficits in American history (Tobin, 1992). Supply-side economics is a failure. In 2008, the American people will have the chance to stop supply-side economics from wreaking further havoc on our political-economy by denouncing the political right.

Supply-side economics is based on the “Laffer Curve,” named after its creator, Arthur Laffer. In 1972 after leaving his government position in disgrace for grossly miscalculating the gross domestic product, Laffer together with his long time friend and protégé Jude Wanninski introduced the United States to the Laffer Curve. The curve stipulates that at a tax rate of zero, government would receive no revenue as no taxes would be collected. At a tax rate of 100% government would not receive any revenue either, since such high taxes would exterminate all capitalistic incentives and bring economic development to a standstill. (Later-on Laffer would show this curve to Dick Cheney, then serving as Chief of Staff for President Gerald Ford. After having the curve drawn on a cocktail napkin in front of him, “...there were a few points Cheney might have made in response... he could have noted that the Laffer Curve was not, strictly speaking, correct” (Chait, 2007a p. 15).) (this information is a little vague, I don’t really see where the author was going with it)

As one might expect, the curve represents an extreme over-simplification; a flawed theory that will inevitably lead to flawed policy. While it is true that excessively high tax rates can dampen, though not completely stop economic growth. The relationship between the top marginal tax rate, the percent of taxes paid by the rich, and economic growth is weaker and far more complex than Laffer assumed. It is possible to derive revenue at a 100% tax

rate. The Soviet Union, while certainly not an example for economic policy was able to sustain one of the world’s largest military apparatuses, exercise political dominance over Eastern Europe, and keep the entire world in a state of anxiety with revenues derived from a 100% tax rate (Chait, 2007a). Moreover, there is no indication that the U.S. is approaching the point where cutting taxes might increase revenue. The relationship between government revenue, economic growth and the tax rate is dependent upon the usage of tax funds. There is no static peak at which the tax rate maximizes government revenue: if tax funds are used as investments in societal welfare, through spending social services and infrastructure, the economy will be able to tolerate, even benefit from higher tax rates (Besci, 2000). The Laffer curve ignores all of the above; its proponents remain under the erroneous impression that the U.S. must cut taxes in order to increase government revenue.

Not surprisingly, the theory that reducing the tax burden of the rich stimulates the economy “has been proven false by experience” (Tobin, 1992). While the top marginal tax rate has the ability to dampen economic growth, the relationship between the top marginal tax rate and economic growth over the course of the second half of the twentieth century suggests that the former has little effect on the latter. During the 1950s, 1960s and 1970s America’s top marginal tax rate was set at, or in excess of 70%. Yet the economy prospered. In the 1980s, the Reagan administration introduced supply-side economics and slashed the top tax rate by 60%, from 70% to 28% (Wilson, 2002). Yet, real GDP growth and median income increases remained well below the levels experienced in the 1950s, 60s and 70s (U.S. Department of Commerce, 2007 & U.S. Census Bureau, 2006a). In the 1990s, the economy

grew enormously despite a tax hike, while remaining unaffected by the Bush tax cuts. The only significant effects supply-side economics has had on American society are an increase in social injustice, chronic lack of government revenue, and the resulting budget deficits. Today, the U.S.

government is faced with the largest budget deficit in U.S. history, and the American people are increasingly divided along economic fault lines that threaten the health and stability of our society.

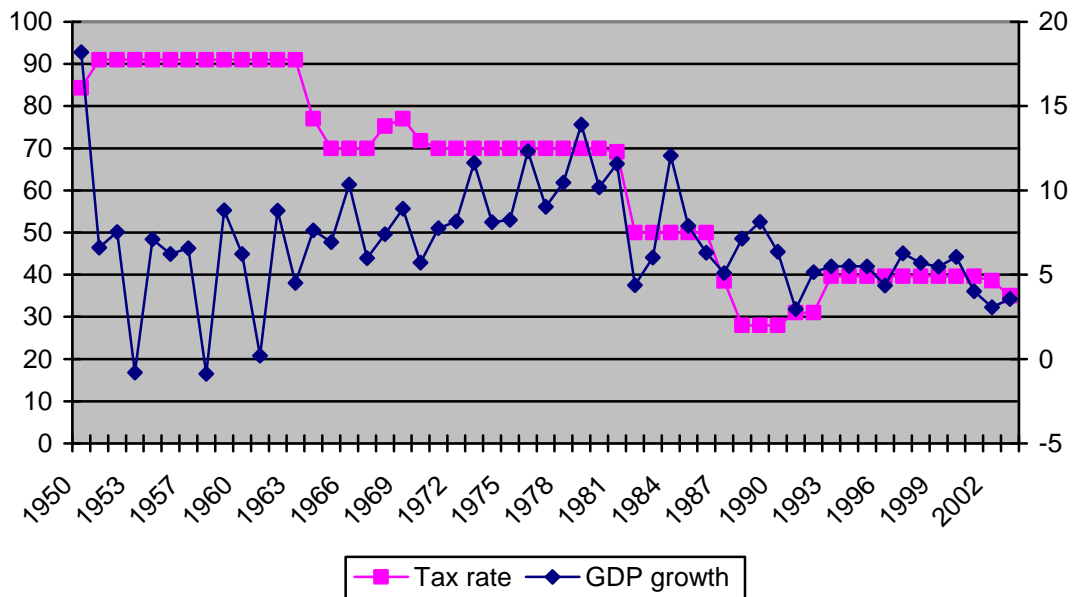


Figure 1. The top marginal tax rate (pink line with percentages on left y axis) has seems to have little effect on annual nominal GDP growth (blue line with percentages on right y axis).

Between 1950 and 1980 the U.S. enjoyed “a massive boom, fueling rapid growth in living standards across the board” (Chait, 2007a). Hamilton College sociologist Dennis Gilbert (1998) refers to the time span between 1946 and 1975 as “the Age of Shared Prosperity” (p. 19). Median income levels increased substantially, the economy showed strong growth and poverty declined. Quarterly growth of the U.S. gross domestic product (GDP) averaged 1.25%, compared to an average of 1% during the 1980s, and 0.5% since 2000 (U.S. Department of Commerce, 2007). Between 1955 and 1979, the median earnings of full-time year round workers increased by an inflation adjusted 66%, from

\$26,000 to \$44,000, for men and by 56%, from \$17,000 to \$26,000, for women (U.S. Census Bureau, 2006a). The percentage of individuals below the federal poverty threshold fell from 22.9% in 1959 to 11.7% in 1979 (U.S. Census Bureau, 2007b). These increases in economic prosperity remain unparalleled. Since 1979, the median income for fully employed men has remained stagnant, as have poverty rates. (U.S. Bureau, 2007b). Following the Korean War, the United States pioneered mass-affluence and became the first society in the history of humankind where the majority of citizens are not members of an economically disadvantaged proletariat (Sachs, 2005). This unprecedented event: the emergence of a so-

ciety in which the privileged outnumber the unprivileged, took place despite a top marginal tax rate in excess of 70%.

Decreasing the top marginal tax rate has, however, increased social injustice significantly. During the same time that the tax burden has shrunk, income inequality has skyrocketed, reaching levels not seen since the pre-depression era (Johnston, 2007). Between 1979 and 2004, “the average after-tax income of the top one percent of the population nearly tripled, rising from \$314,000 to nearly \$868,000 — for a total increase of \$554,000.” During this time span, the top 1% has left even the upper quintile behind. Average net income increased 176% for the top 1%, compared to 69% for the top quintile, 29% for fourth quintile, 21% for the middle quintile, 17% for the second quintile and a mere 6% for the bottom quintile, respectively. Accord-

ing to these figures, the average income of the top percentile has increased 167% as fast as that of the top 20% overall. The share of income earned by the top 1% has doubled, from earning 7.5% to 14% of all income (Aviva & Sherman, 2007).

America has even surpassed ancient Rome in terms of income inequality. In 2005, the share of income earned by the top 1/10,000 of Americans (3%) was three times as large as the share of income earned by the top 1/10,000 in the Roman Empire (1%) in 14 A.C.E (Chait, 2007a). Supply-side economics has been one of the driving forces behind the rising inequality with “Direct estimates by the Urban Institute-Brookings Institution Tax Policy Center... [providing] definitive evidence that... tax cuts have widened income inequality” (Aviva & Sherman, 2007).

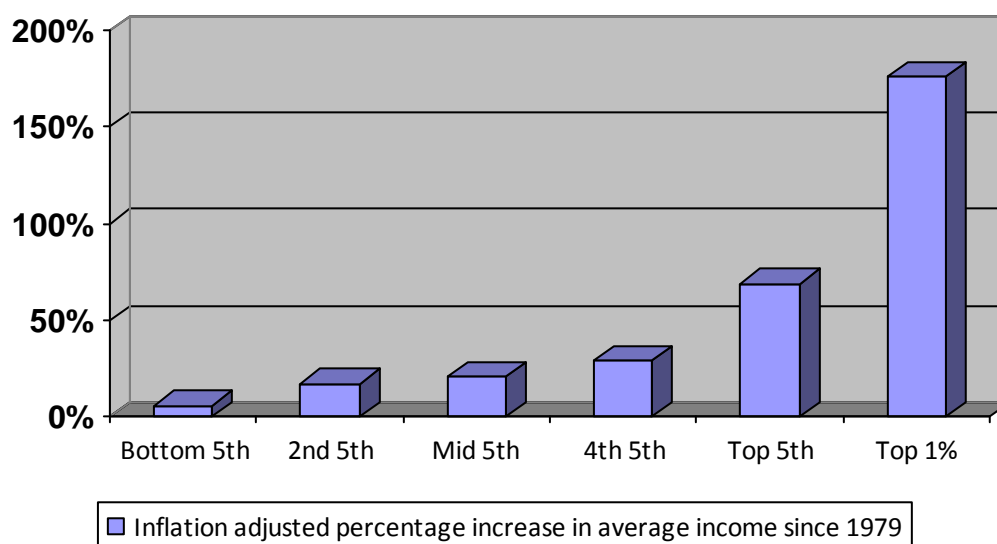


Figure 2. The top 1% has received far larger inflation adjusted income gains since 1979 than any other demographic.

Not suprisingly, most economists see income inequality as a grave problem, and have been alienated by the supply-side dogma of the political right. A recent survey by the Southern Economic Journal

found that 71% of American economists believe that income disparities in the U.S. have grown too large and over 80% believe that it is the role of government to redistribute income. Economists have

abandoned the Republican Party along with the political right. Nearly two thirds of economists identify themselves as progressive with less than 20% identifying themselves as conservative. Democrats outnumber Republicans almost three to one among members of the profession (Klein, 2004). Even Alan Greenspan, one of the relatively few conservative American economists, stated that income inequality is “not the type of thing which a democratic society—a capitalist democratic society—can really accept without addressing” (Greenspan in Pizzigati, 2005). In the community of American economists, supply-siders represent little more than “a tiny coterie of right-wing economic extremists” (Chait, 2007a, p. 1).

In order to convince the public that income inequality is not as grave a problem as it actually is, conservatives commonly put the top 1% together with the rest of the top quintile. In a response to a statement by John Edwards that the U.S. is becoming a country divided between “haves” and “have-nots,” the conservative Heritage Foundation published “Two Americas: One Rich, One Poor? Understanding Income Inequality in the United States.” In this article, Robert Rector and Rea Hederman Jr. (2004) use the household income quintiles to argue that income inequality is not as great as it seems and well justified in its extent. They argue that households in the top fifth are larger with more income earners who work harder and are better educated; thus, they are in need and deserving of higher incomes. Households in the lower two quintiles, on the other hand, tend to be smaller with fewer income earners who are less educated and less productive. Furthermore, differences in household income between the quintiles may be off-set by differences in household size. After all, a household of two making \$75,000 annually may very well have a

higher standard of living than a family four making \$120,000 (Hederman & Rector, 2004).

The observations made by Rector and Hederman are correct, but irrelevant. Of households in the top quintile – those with incomes exceeding \$84,000 in 2004 – 76% had two or more income earners, 62% of householders were college graduates and 82% had some college education, compared to 42%, 27% and 55% among the general public, respectively (see figure 3). Almost three quarters, 73%, took less than two weeks of vacation per year (U.S. Census Bureau, 2006c), performing one third of all labor in the U.S. After adjusting the disparity between the top and bottom quintile for size, taxes and government transfers, Rector and Hederman conclude that “the top fifth of the population has \$4.21 of income for every \$1.00 at the bottom” rather than “\$14.30 of income for every \$1.00 at the bottom.” While they have proven that the disparity between the top and bottom quintiles does not constitute great social injustice, they have not addressed the gaping canyon of inequality that is forming between the top 1% and everyone else. They have failed to address how supply-side economics is causing the very rich to pull far ahead of hard-working middle and upper-middle class individuals in the top quintile. Individuals who do pay their fair share in taxes. The effect of supply-side economics has not manifested itself in the disparities between the top and bottom fifth – the working poor and the middle class, but in the gaping hole between the very rich and everyone else.

Even though, it is difficult for individuals to realize that they are being left-behind by the rich, so long as they too experience increases in their absolute standard of living (i.e. an overall increase in their household income – even if they still

fall short of keeping up with the top), more and more Americans are taking note of the large inequalities that are now dividing our nation. According to a 2007 study by the Pew Research Center, “over the past two decades, a growing share of the public has

come to the view that American society is divided into two groups, the ‘haves’ and the ‘have-nots.’” For the first time in twenty years as many Americans now see the U.S. as a divided nation (48%) as those who do not (48%).

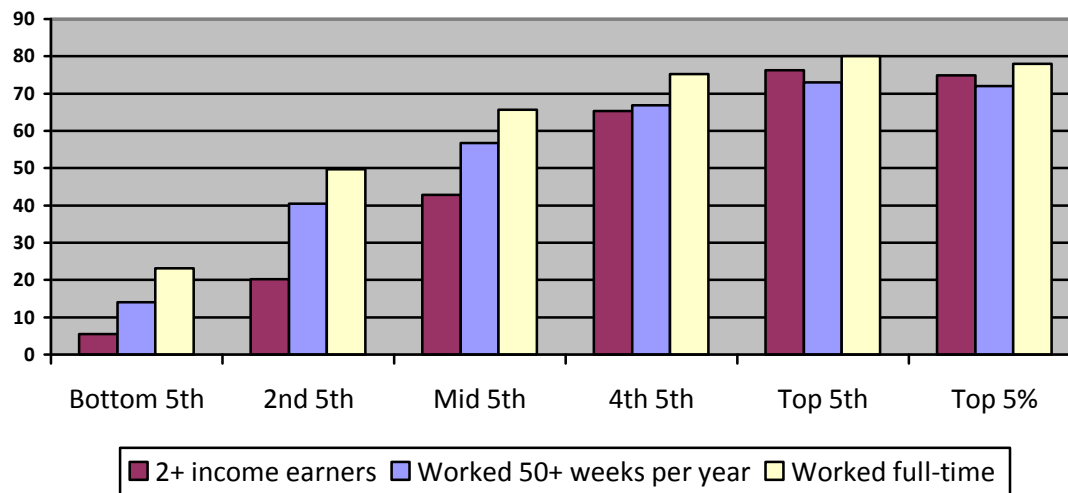


Figure 3. Percent of households and householders with selected characteristics in each income quintile and top 5% (U.S. Census Bureau, 2006c).

These findings mark a strong departure from public sentiment of the 1980s, when Americans overwhelmingly rejected the notion of a divided society. Since 1988 the percentage of those who see the U.S. divided has increased by 84%, from 26% to 48%. (Allen, 2007) The increasing income gaps have dampened Americans' overall view of the economy as well. In 2006, only 34% saw the economy as being in “excellent/good shape.” Even among members of the upper quartile, households earning more than \$75,000, only 41% saw the economy as being in good shape (see figure 4). While “macro-indicators are generally reassuring,” with low inflation, robust growth and increased productivity, the confidence of the 1990s is gone (Allen & Kohut, 2006). It seems that a plurality of Americans has noticed, “that in recent years only the most affluent workers have experienced real gains in wages” (Allen,

2007) and are now dissatisfied with the overall state of the economy.

In addition to increasing income inequality, reducing Americans' confidence in their national economy, supply side economics has failed to produce the promised economic growth and produced the largest government deficits in the history of the United States. Between 1982 and 1993 the average annual deficit constituted 4.3% of GDP, compared to a mere 0.1% under the Clinton administration and an overall historical average of 1.2%. The presidential administrations from Harry Truman to Jimmy Carter managed to decrease annual debt as a percentage of GDP by 70.4%. The Reagan and Bush Sr. administrations, however, reversed this trend by increasing the annual deficit as percentage of GDP by 23.6% (Aaron-Dine & Kogan, 2006). Not all deficits are, however, harmful to society. Moderate deficit can actually help ad-

vance public well-fare, especially when funds are used to invest in the public sector, such as through increased spending on education or infrastructure. Yet, the deficits incurred during the 1980s were neither moderate nor incurred through investment in social services, but rather depriving government of revenue. These deficits reached “sufficiently high levels that the compounding of interest on the debt

[caused] the debt to grow faster than the economy.” This trend can lead to a “debt explosion” where “debt would begin to grow explosively and threaten the functioning of the economy” (Greenstein & Kogan, 1997). Overall, during the 1980s, supply-side economics drove the U.S. government into debt at a potentially devastating pace.

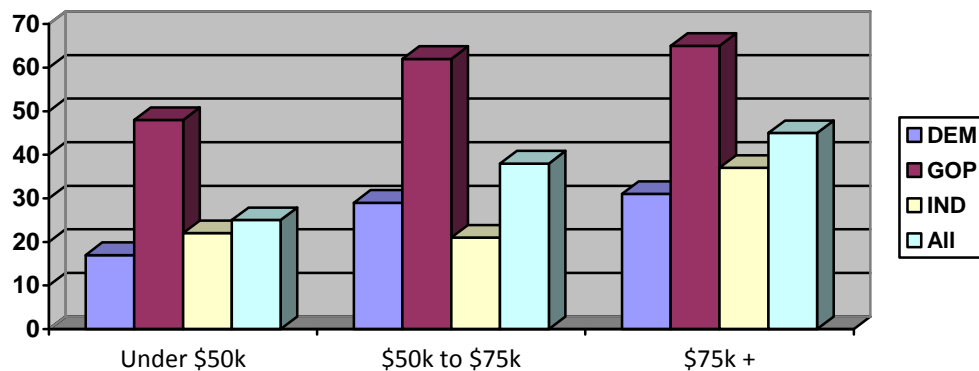


Figure 4. Percent of respondents evaluating the economy as being in good shape by partisan affiliation and gross annual household income (Allen & Kohut, 2006).

When government is deprived of funds and forced to pay an increasing share of its reduced revenue on debt repayment and interest, social services suffer. The cost of foregoing investment in the social sector in order to pay for tax cuts bestowed upon the rich is unacceptable. The condition of America’s infrastructure is a prime example. The American Society of Civil Engineers (ASCE) gives U.S. infrastructure a grade of D, with drinking water and waste water facilities being given a D minus. The association estimates that \$1.6 trillion are needed over the next five years to repair the nation’s physical plant. According to the ASCE, “Congested highways, overflowing sewers and corroding bridges are constant reminders of the looming crisis that jeopardizes our nation’s prosperity and our quality of life” (ASCE, 2007). The cost of repairing “obsolete or deteriorating bridges” alone amounts to \$7.4 billion per

year. The main cause of this “looming crisis” is easy to locate: reduced spending. In the late 1950s to early 1970s, the U.S. spent over 2% of GDP on infrastructure, compared to roughly 1% of GDP since the early 1980s (Author, Author & Author, 2007). Supply-side economics has reduced tax revenue and increased debt. Therefore, the funding of important government services, such as maintaining the nation’s physical plant, have suffered.

Despite the letdown of supply-side economics and the grave need for increased government revenue, the Bush administration has decided to ignore the lessons of history and revive the economic policies of the 1980s. Ignored are the successes of the Clinton administration, which raised the top marginal tax rate by 27.5%, balanced four consecutive budgets and lowered poverty rates to levels not seen since the 1970s. Ignored is the legacy of the



1980s as a decade of greed and injustice (Ehrenreich, 1989). Ignored is the scientific consensus among economists that supply-side economics are an utter and complete failure (Chait, 2007a). The brief revival of fiscal responsibility, social justice and progressive taxation of the 1990s has been replaced by the dated Reaganesque supply-side dogma of the political right-wing. Before Bush signed the 2003 tax cuts into law, ten Nobel price laureates, George Akerlof, Kenneth J. Arrow, Franco Modigliani, Paul A. Samuelson, Douglas C. North, Lawrence R. Klein, Robert M. Solow, William F. Sharpe, Daniel L. McFadden, and Joseph

Stiglitz signed the “Economists’ Statement Opposing The Bush Tax Cuts.” The 2003 statement reads:

....Overcapacity, corporate scandals, and uncertainty have and will continue to weigh down the economy.

The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus...

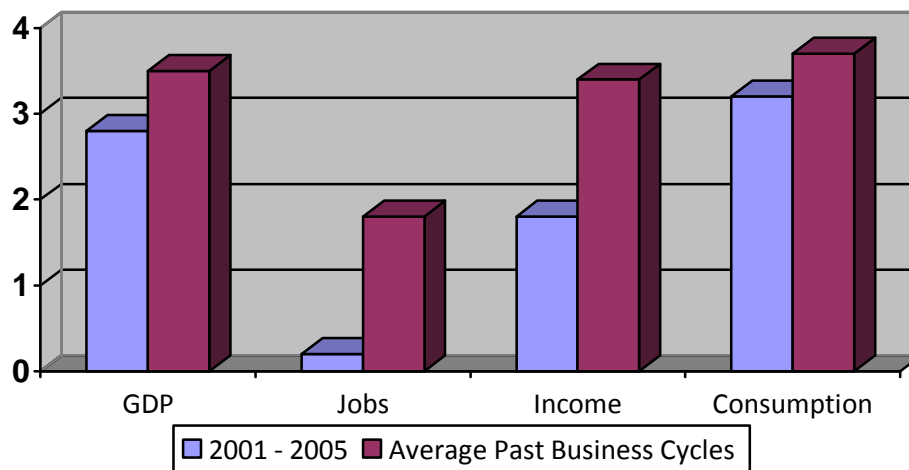


Figure 5. Annual percentage growth in GDP, number of paid jobs, personal income and consumption was below average for the 2001 to 2005 business cycle (Author, 2005).

Passing these tax cuts will worsen the long-term budget outlook, adding to the nation’s projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income...

The Bush tax cuts epitomize the dramatic flaws of supply-side economics and the dire predications of the ten Nobel price

laureates have come true. The Bush tax cuts have cost roughly \$1.2 trillion between 2001 and 2006 (Fielder & Kogan, 2006). “Proponents of these tax cuts promised stronger economic gains than were typical of the past, but that did not occur” (Price & Ratner, 2005). With the sole exception of the housing market, economic performance has been below average since the Bush administration started manipulating the tax code in 2001 (see figure 5). Between 2001 and 2005, GDP growth was 17.6% below average, while GDI (Gross

Domestic Income) growth was 36% below average. The number of jobs created grew by only 6.5%, 28.5% below the average growth rate of 9.1%. The growth in average salaries was less than half as usual; 1.2% versus 2.7%, respectively. While growth in consumer spending was 72% faster than growth in income, it too has “failed to keep pace with the... average of previous cycles.” Only investment residential real-estate soared, growing 26% faster than average, creating the now infamous housing bubble. “A review of economic performance over the last four-and-a-half years indicates that the series of major tax cuts enacted in that time have not strengthened the economy. Almost every broad measure of economic activity... has fared worse over the last four-and-a-half years than in past cycles” (Price, 2005). It is, therefore, clear that the Bush tax cuts have missed their objective.

What has ballooned as a result of the Bush tax cuts is the national deficit (see figure 6). While in 2001 the “Congressional Budget Office projected budget surpluses of \$5.6 trillion from 2002 to 2011... [by 2003 it projected] hundreds of billions

of dollars in deficits over the same period” (Gale & Orszag, 2003). The Bush tax cuts have been the single largest contributor to the \$1.8 trillion the government borrowed between 2001 and 2007; their cost comprising 51% of increased debt. On September 30, 2007, U.S. public debt was clocked at \$5.1 trillion, up 54% from \$3.3 trillion in October 2001 (U.S. Treasury, 2007). The Bush administration received ample warning that its tax cuts would create fiscal nightmare, as “even President Bush’s own Council of Economic Advisors has written that the tax cuts would make the budget deficit worse.” The Bush tax cuts are a “huge fiscal gamble... [that] burdens... future generations” (Gale & Orszag, 2003). In sight of the cost of baby-boomers starting to accept their entitlements and a war that will likely cost \$2.7 trillion (Reuters, 2007), increasing the deficit through tax cuts for the rich is simply “reckless” (Gale & Orszag, 2003). The Bush administration’s approach to fiscal policy may be best described as quitting one’s job before purchasing a brand new Mercedes-Benz.

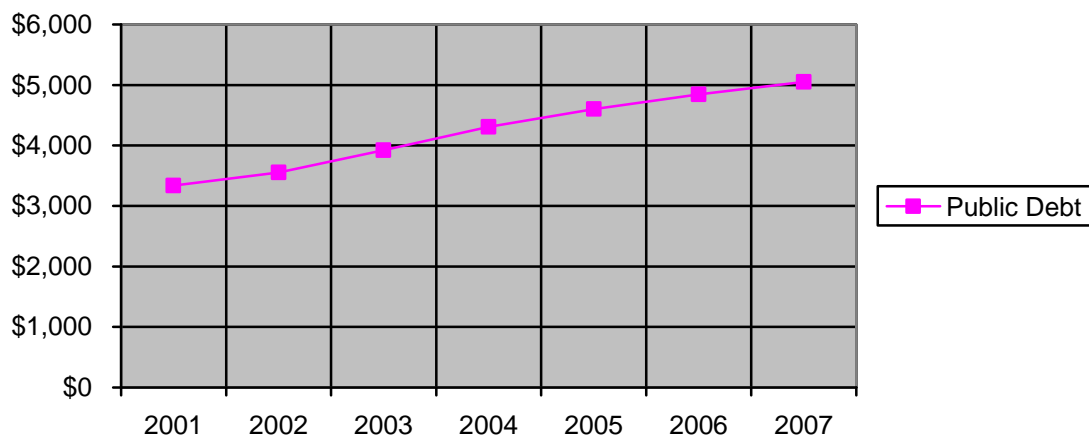



Figure 6. Public debt in billions from January 2001 to September 2007, showing an increase of roughly 54% (Author, 2007).

The Bush tax cuts have exemplified the flawed nature of supply-side economics. Yet, “every Republican candidate running for president in 2008 has pledged that the tax cuts President Bush pushed through Congress... should continue indefinitely” with additional promise to “never to allow income taxes to increase...” (Redburn, 2007). While the tax rates of the 1940s, 50s, 60s and 70s may have theoretically inhibited economic growth (though the economic grew strongly in spite of them), the current top marginal tax rate is too low, needlessly depriving government of revenues. These funds are, however, needed to expand and improve social services, repair the rapidly deteriorating infrastructure and prepare for the flood of entitlement claims that will ensue once baby-boomers start retiring. Cutting taxes of the rich has failed to produce the economic growth it promised, ballooned national debt and increased income inequality.

Coming November 2008, the American public will have the opportunity to end supply-side economics, reduce income inequality and give government the access to funds it desperately needs to serve the American people. It is time to repeal the Bush tax cuts, which have already cost us \$1.2 trillion, not counting the opportunity cost of withholding funds from social services. It is time that the public and policy makers listen to economists. It is time to prepare for the future, restore social justice and revive fiscal responsibility. It is time to discard supply-side economics as the rubbish it is and free the White House from failed rightist economic dogma. 

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